

The Federal Reserve System: Balancing Independence and Accountability

World Affairs Council of Philadelphia

Philadelphia, Pennsylvania

February 17, 2010

Charles I. Plosser

President and CEO
Federal Reserve Bank of Philadelphia



FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed today are my own and not necessarily
those of the Federal Reserve System or the FOMC.

The Federal Reserve System: Balancing Independence and Accountability

World Affairs Council of Philadelphia
Philadelphia, Pennsylvania
February 17, 2010

Charles I. Plosser
President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

Introduction

Good afternoon. Thank you for inviting me to speak before the World Affairs Council of Philadelphia. For more than 60 years, this organization has discussed some of the world's most challenging issues and my topic today certainly falls into that category. In the aftermath of the global financial crisis, some have asked whether the governance and structure of the Federal Reserve System should be overhauled. I would like to take this opportunity to explain why I believe the system that Congress established nearly 100 years ago still serves the public interest and why some of the proposals to change the Fed's structure are misguided and even pose serious risks to the health of our economy.

President Woodrow Wilson and Congress intentionally structured the Federal Reserve with checks and balances to protect and serve our diverse nation. Americans have a long history of suspicion toward the concentration of authority. So, our uniquely American form of a central bank strikes a balance between centralization and decentralization; between the public and private sectors; and among Washington, Wall Street, and Main Street. The result is a central bank that achieves a delicate balance: it permits policymakers a good deal of independence when conducting monetary policy but in return requires transparency and accountability to the American people.

Yet, recently there have been calls to restructure the Federal Reserve. This is not too surprising in the aftermath of the economic turmoil of the past two years. We are

emerging from a global financial crisis that led to one of the deepest and most severe recessions since World War II. In response, central banks around the world took unprecedented actions. In the U.S., the Federal Reserve aggressively eased monetary policy by reducing the target federal funds rate effectively to zero and has left short-term interest rates at these extraordinarily low levels for more than a year. The Fed and other central banks also took a number of other actions intended to provide liquidity and credit to frozen financial markets.

Fortunately, financial market conditions are considerably better than they were a year ago and the worst of the financial crisis now appears to be behind us. In light of this improvement, the Fed allowed most of its temporary special liquidity programs to expire on February 1. Although we have yet to see robust employment growth, there are signs that labor market conditions are starting to slowly improve and it appears that a modest economic recovery has begun.

Policymakers and lawmakers are now turning their attention to ways to avert future crises. Legislators, both here and abroad, are considering revisions to financial regulations, the role central banks should play in financial supervision, as well as the structure and governance of the central banks. Unfortunately, some initiatives would strike at the very foundations of sound and responsible central banking.

My focus today will be on what I regard as the most important of all principles of sound central banking — the independence of monetary policy. Threats to this independence appear in several forms. For example, the “Audit the Fed” amendment passed by the U.S. House of Representatives in December would allow any legislator to demand the Government Accountability Office, or GAO, to “audit” the Fed’s monetary policy decisions.

The amendment does not refer to an “audit” in the usual accounting sense of the term, since the Fed’s financial statements and controls are already subject to extensive outside audits by the GAO and a public accounting firm. Rather, this proposal is an

attempt to reduce the independence of the central bank through the threat of a political action. In particular, the GAO could be called on to investigate a monetary policy decision whenever any member of Congress opposes a decision to change interest rates. This would undermine the Fed's credibility and its ability to conduct monetary policy in the long-term interests of the American public.

Another way independence is currently threatened arises from efforts to make political appointees out of the Reserve Bank presidents or members of their boards of directors. Both the threat of "policy audits" and the political appointment of presidents or directors are not-so subtle efforts to politicize the Federal Reserve.

These changes run counter to history and the principles of sound and responsible central banking. Over the past 30 years, many countries have acted to increase the degree of independence of monetary policymaking from short-term political influences. These moves reflect empirical research that generally shows that developed countries whose central banks have greater independence tend to have lower and more stable inflation without sacrificing employment or output, thus benefiting from more stable economies and better economic performance.

The assault on central banks is not confined to the U.S. It is showing up in a number of countries and in different ways. Just since January 1, 2010, here is a sampling from recent news reports of what central bankers have faced in other countries:¹

Argentina's president fired the governor of the central bank when he refused to transfer \$6.6 billion in foreign-exchange reserves to the government's coffers to meet fiscal expenses ahead of next year's election.

South Korea's president, not surprisingly, has urged the Bank of Korea to go slow on its exit strategy from accommodative monetary policy. However, to underscore the point,

¹ For a summary of recent challenges to central bank independence, see Jon Hilsenrath, Brian Blackstone, and Jaeyeon Woo, "Crisis Threatens to Curb Central Banks," *Wall Street Journal*, January 12, 2010.

he sent a vice minister to attend a Monetary Policy Committee meeting for the first time in a decade.

Japan's new administration has put increasing pressure on the Bank of Japan to increase lending. This month, the new finance minister said he was looking for even more cooperation from Japan's central bank.

Mexico's president has appointed a new governor for the Bank of Mexico, after clashing with its former governor over the central bank's reluctance to cut interest rates.

These efforts, along with the proposals that would politicize the Federal Reserve here in the U.S., are deeply troubling. While many try to interpret these efforts as logical or inconsequential, they are not — they are misguided and potentially damaging to the nation's economic well-being.

Central Bank Independence

Why is central bank independence so important?

Despite research that indicates countries with independent central banks generally produce more desirable economic outcomes, it strikes many people as odd that in a democratic society we leave monetary policy decisions in the hands of nonelected policymakers who can act with independence. I think this view stems from confusion about what is really meant by central bank independence. Central bank independence means that the central bank can make monetary policy decisions without fear of direct political interference. It does not mean that the central bank is not accountable for its policies.

It is important to remember that the Federal Reserve does not select its own goals. Instead, Congress sets the goals it wants the Fed to pursue with monetary policy. The Federal Reserve Act states that the Fed should conduct monetary policy to “promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” Since moderate long-term interest rates generally result when prices

are stable and the economy is operating at full employment, it is often said that Congress has given the Fed a dual mandate.

What central bank independence does mean is that Congress has left the decisions of how best to achieve this mandate to Fed policymakers. Why did Congress design the Fed this way? There are two very good reasons. First, monetary policy affects the economy with sometimes long and variable lags, but elected politicians, and even the public, often have shorter time horizons. Monetary policy actions taken today will not have their full effect on the economy for at least several quarters and perhaps as long as several years. That is why monetary policy choices today must focus on the intermediate to long term and anticipate what the economy might look like over the next one to three years.

Moreover, there can be a conflict between what monetary policy may be able to achieve over the short term versus its impact over the long term. For example, in the short term, it might seem expedient or even desirable to try to spur economic growth and employment by setting excessively accommodative monetary policy. Yet, this will only lead to very bad economic outcomes in the long term — including higher inflation, higher interest rates, and an eventual tightening of policy to control inflation that may be detrimental to the economy. These outcomes would be inconsistent with the long-term goals set by Congress. Delegating the decision-making to an independent central bank that can focus on long-term policy goals is a way of limiting the temptation for short-term gains at the expense of the future.

The second important reason to give monetary policy decision-making to an independent central bank is to separate the authority of those in government responsible for making the decisions to spend and tax from those responsible for printing the money. This lessens the temptation for the fiscal authority to use the printing press to fund its public spending, thereby substituting a hidden tax of inflation in the future for taxes or spending cuts.

This can be especially important when governments face huge deficits and may choose to look to the monetary printing press to improperly fund fiscal needs — as in Argentina today. The fiscal authorities should not think of the central bank as a source of funds or a piggy bank simply to avoid the difficult choices of cutting spending or raising taxes. Efforts to politicize central banks can be seen as a way for the fiscal authorities to strengthen their influence on the printing press to avoid difficult fiscal choices.

History is replete with examples in which central banks became agents for a nation's fiscal policy or a means for a political party to remain in power. Just in the 20th century think of the hyperinflation in Germany between the World Wars; think of Italy before the euro; think of the numerous financial crises in Latin America, and the current economic chaos in Zimbabwe to name just a few. The consequences — higher inflation, currency crises, and economic instability — are not good.

Indeed, we live in a world of highly mobile capital and financial markets that are constantly assessing the credibility of governments and their central banks to maintain price and economic stability. In such a world, the mere threat that monetary policy might become politicized can damage the nation's credibility. It can raise fears of inflation that send interest rates higher and currencies falling.

Thus, there are sound reasons for monetary policymaking to remain independent of the political process.

Independence in the Current Structure of the Fed

Here in the United States, central bank independence has been an important part of our history from the founding of the Federal Reserve System in 1913. As former Fed Vice Chairman Alan Blinder has explained, Congress designed the Fed this way because it knew the temptation to interfere with monetary policy was great and that such interference would be detrimental to society. So Congress tied its own hands, just as

Ulysses had himself tied to the mast of his ship as it sailed past the beautiful and tempting, but deadly, Sirens.²

The Federal Reserve's governance structure is one important mechanism for preserving its independence. Congress established the Federal Reserve System with 12 regional Reserve Banks overseen by a Board of Governors in Washington, D.C. This structure grew out of the frustration with the centralized nature of our nation's two previous attempts at a central bank. Both the First and Second Banks of the United States, whose last vestiges are just a few blocks from here, were highly centralized institutions located in what was then the political and financial center of the nation.

As Congress debated the creation of the Federal Reserve, it did not want to vest too much authority in a single institution. So it created a more decentralized structure with 12 regional Reserves Banks, each independently chartered, and each with its own nine-member board of directors drawn from citizens in their respective Districts. Among the responsibilities of these directors is selecting the Reserve Bank president, but subject to the approval of the Board of Governors in Washington. This structure is designed to insulate presidents and directors from short-term partisan politics.

Unlike Reserve Bank presidents, members of the Board of Governors are appointed by the President and confirmed by the Senate, and thus are directly connected to the political process and the public sector. Congress provided that Fed Governors could serve 14-year terms to insulate them from short-term political pressures and to encourage a long-term perspective on the economy and the financial system.

Congress also ensured a decentralized approach in the structure of the Federal Open Market Committee, or FOMC, which is the primary body responsible for setting and implementing monetary policy. In 1935, Congress gave votes to the seven Governors in Washington, along with five of the 12 regional Reserve Bank presidents on a rotating

² Alan S. Blinder, "Is Government Too Political?" *Foreign Affairs*, 76 (November/December 1997), pp. 115-26.

basis. With seven Governors, the Board retains the majority of votes on the FOMC, even though all 12 Reserve Bank presidents always participate in the discussions at FOMC meetings.³

The 12 regional Reserve Banks give the Federal Reserve deep roots in the nation's communities, which allows the System to better understand various aspects of the economic diversity of our country and to stay in touch with Main Street, not just Wall Street. Reserve Banks also have Branch boards, advisory boards, councils, and other mechanisms to keep abreast of events in their regional economies. Thus, presidents bring a rich array of information and views from around the country to help formulate national monetary policy.

Congress also made the Fed independent from the Treasury and the administration. The Fed receives no government appropriations from Congress, again as a way of depoliticizing the central bank. In fact, the System turns over any excess earnings on its portfolio of securities and loans above the cost of its operations to the U.S. Treasury. In 2009, this amounted to about \$46 billion.

Accountability and Transparency

Being independent does not mean the Fed is unaccountable. The Fed is ultimately accountable to Congress and the American people. Having been granted the independence required to implement effective monetary policy on behalf of the country, the Fed has a duty to explain and be held accountable for its policy decisions to Congress and the public. The Fed Chairman testifies to Congress on monetary policy at least twice each year and frequently appears before House and Senate committees to answer questions. The Chairman's recent reconfirmation vote is a part of that accountability process.

³ There are currently five Governors serving, with two open seats on the Board of Governors.

The Reserve Banks' structure also helps increase transparency by communicating economic and monetary policy objectives and actions through educational outreach and speeches like this one, as well as discussions with their boards of directors and other groups.

The Fed has increased the degree of transparency regarding its monetary policy decisions over the past two decades. The FOMC issues a statement after each meeting, detailed minutes three weeks later, and verbatim transcripts after five years. The Fed publishes weekly balance sheets, monthly and quarterly reports, and detailed annual financial statements audited by an independent public accounting firm. The GAO also frequently audits many of the Fed's functions, including its supervisory and regulatory functions and its services to the U.S. Treasury.

So why is the Fed opposed to the "Audit the Fed" amendment? Since 1978, Congress has specifically exempted monetary policy decisions from such "audits" with good reason. If we politicize monetary policy by removing that exemption, individual members of Congress would have the ability to challenge monetary policy decisions at will. As I noted earlier, such an attempt to politicize monetary policy is wrongheaded — it would ultimately result in less effective monetary policy for the American people.

Another frequently mentioned proposal under consideration would politicize the governance of the 12 Reserve Banks by making the chairs of the boards of directors, or the Reserve Bank presidents, political appointees. Other legislators have suggested eliminating the votes of Reserve Bank presidents on the Federal Open Market Committee.

As I hope I've explained, such changes would weaken the regional and decentralized structure of the Federal Reserve System and lead to a more centralized and political institution and less effective policy. Were regional Reserve Bank presidents or chairs to become political appointees, they might be more attuned to the political process in Washington that selected them, rather than having a public interest in the broad

economic health of the nation and the Reserve Districts in which they reside. Politicizing these important positions might also discourage some talented, public-spirited individuals to serve as part of our nation's central bank.

Some Suggestions for A Way Forward

Am I surprised that these types of proposals are surfacing at this time? Not really. It is natural to rethink institutions and decisions after such a large financial and economic crisis. Fortunately, such crises are rare events.

Quite frankly, in my view, some of the actions that the Fed took in response to the crisis in order to ensure financial stability blurred the line between monetary policy and fiscal policy, thereby increasing the risk to the Fed's independence. The Fed lent to some firms that were deemed too big to fail and established unprecedented lending programs, many of which were justified under what is known as 13(3) authority, which allows the Fed to lend to corporations, individuals, and partnerships under "unusual and exigent circumstances."

In addition, the Fed greatly increased the size of its balance sheet and changed its composition, substituting less liquid, long-term assets, such as securities backed by mortgages guaranteed by Fannie Mae and Freddie Mac, for the short-term Treasury securities it typically held before the crisis. These policies have veered toward deciding how public money should be allocated across firms and sectors of the economy. I believe that if the government must intervene in allocating credit in this manner, such decisions properly belong to the fiscal authorities — not to the central bank. By making these unprecedented lending decisions, and at times being less transparent than we could have been, the Fed has opened itself up to criticism from various sources and has encouraged the idea that monetary policy decisions may be influenced by political or other special interests. This is not a healthy development.

To promote a clearer distinction between monetary policy and fiscal policy and to help safeguard the Fed's independence, I advocate that we implement monetary policy using

a portfolio that contains only Treasury securities, preferably concentrated in bills and short-term coupon bonds. Like Ulysses and the Sirens, the Fed could help preserve its independence by limiting the scope of its ability to engage in activities that blur the boundary lines between monetary and fiscal policy. Thus, as the economic recovery gains strength and monetary policy begins to normalize, I would favor our beginning to sell some of the agency mortgage-backed securities from our portfolio rather than relying only on redemptions of these assets. Doing so would help extricate the Fed from the realm of fiscal policy and housing finance. It will take some time for the Fed's portfolio to return to its pre-crisis composition, but we should begin taking steps in that direction sooner rather than later.

I also believe that the Fed's 13(3) lending authority should be either eliminated or severely curtailed. Such lending should be done by the fiscal authorities only in emergencies and, if the Fed is involved, only upon the written request of the Treasury. Any non-Treasury securities or collateral acquired by the Fed under such lending should be promptly swapped for Treasury securities so that it is clear that the responsibility and accountability for such lending rests explicitly with the fiscal authorities, not the Federal Reserve. To codify this arrangement, I believe we should establish a new Fed-Treasury Accord, a step that I began to publicly advocate almost a year ago.⁴ This would eliminate the ability of the Fed to engage in "bailouts" of individual firms or sectors and place such responsibility with the Treasury and Congress, squarely where it belongs.

Finally, I think we must work harder to enhance and improve the transparency of the Federal Reserve. We have come a long way in the last 20 years, but the actions I have just mentioned — adopting an explicit Treasuries-only policy and eliminating or vastly restricting 13(3) authority through a new Fed-Treasury Accord — can help restore the public's confidence and trust in the institution and preserve our independence to conduct sound monetary policy on behalf of the entire nation.

⁴ See Charles I. Plosser, "Ensuring Sound Monetary Policy in the Aftermath of Crisis," speech at the U.S. Monetary Policy Forum, New York, February 27, 2009.

Conclusion

In closing, nearly a century ago, there were valid reasons for creating an independent and decentralized central banking system. Those reasons remain valid today.

Upsetting the current structure's checks and balances puts at risk the Fed's ability to deliver on the monetary policy goals set by Congress: price stability and maximum employment. Recent proposals that remove the GAO exemption for monetary policy would politicize the decision-making and risk sowing the seeds of higher inflation and economic instability. Making Reserve Bank presidents or the chairs of their boards of directors political appointees would also reduce the checks and balances between the public and private sectors, weaken an important source of independent voices in the Federal Reserve System, and limit the input of Main Street's views.

The independence of the Fed or any central bank does not guarantee all policy choices will be wise or perfect — particularly in hindsight. I will be the first to acknowledge, and during my academic career frequently pointed out, that the Fed has made its share of mistakes. The Great Inflation of the 1970s is a perfect example. Indeed, the cause of the Great Inflation stems directly from political pressures on the Fed to help finance the Vietnam War by creating money, which it did, and pressure to provide excessive and prolonged policy accommodation in the face of the oil shocks of the 1970s, which it also did. Thus, this was a failure of the Fed's not exercising its independence to resist political pressure. Not one of our prouder moments. Yet economic theory and the historical record suggest that turning monetary policy and thus the printing of money over to the fiscal authorities or the political process would be worse. Indeed, I would ask those who think the Fed kept interest rates too low for too long in the early part of this decade to imagine the outcome had the process been more political. I doubt the result would have been that rates would have risen sooner or faster.

Strict limits or outright prohibitions on the Fed's ability to engage in 13(3) lending under a new Fed-Treasury Accord would help restore a more explicit separation between

monetary and fiscal policy and help preserve the Fed's independence and the public's trust. Returning our portfolio to all Treasuries and committing to a Treasuries-only policy would reduce pressures on the Fed to use its balance sheet to engage in fiscal action.

In the aftermath of the financial crisis and large fiscal deficits, the Fed still faces significant challenges. I believe we can exit from the extraordinary stimulus we have provided without generating a serious risk of inflation in the intermediate to long term, but to do so will require some careful and difficult policy choices. Monetary policymakers must have the courage and independence to make these difficult choices. Politicizing that decision-making process will not deliver the desired outcomes and runs counter to responsible and sound central bank practice.